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DAN SMOOT

TAX REFORM — PART II

The Revenue Bill of 1962 permits business firms to deduct, as a tax exemption, 7 per cent of everything they spend for new equipment and production facilities.[1]

President John F. Kennedy and the 87th Congress intended the investment-credit tax to be a permanent feature of the federal income-tax system — as an incentive to stimulate growth and improvement of production facilities. President Richard M. Nixon and the 91st Congress consider the investment-credit tax a loophole which enables businesses to avoid paying some $2.5 billion in federal income taxes each year. The Tax Reform Act of 1969 (already passed by an overwhelming majority in the House, now pending in the Senate) would repeal the investment-credit tax, retroactive to April 18, 1969.[2]

Any incentive tax is objectionable in a free society, because it places government tax writers in the position of deciding what goods or services the people should produce and buy. The tax writers are primarily responsive to political pressures. They tend to put special incentives into the tax code, not for sound economic reasons, but for the purpose of winning political support for themselves and party.

Yet, after a particular incentive tax becomes imbedded in a general tax code built on inequitable incentives, special privileges, and discriminatory exemptions (as our federal income-tax system is), removing the particular incentive without abolishing the entire general tax code often does more harm than good. This is the situation we are now in with regard to the investment-credit tax.

The investment-credit tax was not enacted to raise revenue, but to provide incentive. Therefore, it is offensive to the principles of liberty. But our entire federal income-tax system is offensive to the principles of liberty. Repealing the investment-credit tax now, before the entire income-tax system is abolished, would do grievous harm.

In 1962 (the year when the investment-credit tax was added to the revenue code), Congress enacted

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the Manpower Development and Training Act, initiating the federal government's first general, comprehensive job-training program.

Government job-training activities have so multiplied since 1962 that federal agencies now spend about $3 billion a year in this field.[3]

The primary job-training emphasis of the Nixon administration is on a program initiated by the Johnson administration — giving special tax subsidies to businesses for training unskilled persons.

Contemplate the consequences of repealing the investment-credit tax, while emphasizing tax-subsidized job training by private industry. The investment-credit tax did stimulate expansion and proliferation of production plants, thus creating new jobs for workers. Repealing the tax will curtail the creation of new jobs. This will increase the emphasis on tax subsidies to private businesses for job training; but those given tax-subsidized job training will be trained for jobs that do not exist. Business firms that formerly concentrated on expansion and creation of new jobs (in order to get the 7% investment-credit *tax advantage*) will concentrate on getting *tax subsidies* for training people whom government wants trained.

The number of workers trained with tax subsidies will grow until there will not be enough real private-industry jobs to go around. This will result in one of two things, or both: (1) government will subsidize businesses to hire and keep employees they do not need; or (2) government will become, as most socialist-liberals are already demanding, an "employer of last resort" — that is, giving make-work, useless, non-productive government jobs to able-bodied adults not otherwise employed.

The expectation that the closing of the investment-credit "loophole" will require businesses to pay $2.5 billion a year more in federal income taxes is based, in part, on the assumption that businesses will continue buying the same quantity of production equipment they bought when they got a 7% tax credit.

They will not. In fact, many businesses will reduce their buying of production equipment *below* what they were buying before the investment-credit tax was enacted in 1962, because prices and interest rates have increased enormously since then.

Consequently, repeal of the investment-credit tax will not appreciably increase federal tax revenues. The repeal will, however, create demand for more taxes, for more tax-subsidized job training, and more tax-subsidized jobs.

Thus, in many ways, elimination of the investment-credit tax — *unless it is eliminated by the abolition of the entire federal income-tax system* — will accelerate our rush toward perversion of our Republic into a complete communist-socialist-fascist dictatorship of the proletariat.

Our internal revenue code is not only grossly inequitable and oppressive, but is also so garbled and complex that it defies understanding. For example, the House-passed Tax Reform Act of 1969 (as reported by *Congressional Quarterly*):

Reduced the 27½% oil-depletion allowance to 20 per cent. Comparable reductions were made with most other minerals, but the present 15 per cent rate for gold, silver, oil shale, copper and iron ore was retained. Other minerals currently receiving a 15 per cent allowance were trimmed to 11 per cent. Those at 23 per cent were cut to 17 per cent, those at 10 to 7, those at 7½ to 5, and those at 5 to 4. The depletion allowance was discontinued for oil operations abroad. However, the allowance was continued for drilling on the continental shelf. The bill provided that mineral production payments were to be treated as loans for tax purposes. A carved-out production payment was to be treated as a mortgage loan on the mineral property, rather than as an economic interest in the property. Thus, the proceeds received

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by a seller of a payment would not be taxable to him. However, income derived from the property after the payment was taxable to the owner, subject to the depletion allowance. In the case of retained production payments, that income derived from the property and used as the production payment was taxed to the property's owner, subject to the depletion allowance. Expected revenue gain from all these changes: $525 million in 1970.

Most of that is quite meaningless to laymen. In fact, I doubt seriously that such jargon is really understood by Congressmen who write tax laws, by Internal Revenue Service people who administer the laws, by courts and other tribunals that adjudicate disputes about the laws, by lawyers who represent tax clients, or by accountants who specialize in filing tax returns for others.

Any tax code so incomprehensible to literate, normally-intelligent taxpayers that they must hire professional specialists to make tax decisions and tax returns, is obviously an undesirable code — even if nothing else were wrong with it. But there is a great deal wrong with our tax code, besides its muddy complexity.

Why should producers of some minerals get bigger percentage depletion than producers of other minerals? How and why did congressional tax writers arrive at such odd percentages as 27½, 17, 7½? What is the justification for *any* percentage depletion allowance?

The 27½% depletion allowance for producers of oil and natural gas was put in the revenue code in 1926.[4] The odd amount has no meaning. It was a compromise resulting from pressures on the Congressmen who wrote the provision.

The depletion allowance is a "tax incentive" provision and is, therefore, offensive to the principles of liberty. Although there are political reasons for every incentive tax, there are also, usually, some economic reasons. There are more economic reasons for the oil and gas depletion allowance than for most other incentive taxes.

There is infinitely more economic risk in drilling a well to produce oil or gas than in building a factory to produce manufactured goods. Before a man builds a factory, he can know (within rather narrow limits) what the plant will cost. Despite all advances in geology and technology, oil-well drillers still run into unpredictable obstacles to completing a producing well.

After a man builds a factory, he has property of value which he can sell to someone else and thereby recover some of his investment, even if he has to close down because the market for his product is not what he anticipated. A man who drills for gas or oil, and finds nothing, suffers a total loss.

Supply of production material for a factory does not deplete or run out with use. But a gas or oil well taps a fixed, irreplaceable quantity of supply which depletes as it is produced; and when the fixed supply is gone, the investment in the production facility is relatively worthless.

These are some of the economic facts that congressional tax writers tried to take into account when creating the 27½ per cent oil depletion allowance tax in 1926.

Granting depletion allowance to producers of oil and natural gas prompted successful demands for similar allowances to producers of about 100 other minerals or natural-deposit materials[4] — the allowances varying with the influence of lobbying interests involved.

Every special-incentive tax (like fast write-off, investment credit, depletion allowance) tends to favor big operators over small, because big operators are in a better position to take advantage of the tax. In the oil industry, for example, a relatively small wildcatter, after gambling his all on exploration, may discover an important new oil field; but many of the wildcatters must sell out, wholly or in part, to major oil firms, because only the majors have the capital resources, facilities, and organized systems necessary for trans-

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portation, processing, and marketing of the oil. Thus, the depletion allowance, intended to encourage dangerous risk of private capital for exploration, sometimes gives as much (or more) reward to big firms which did not take the risk, as it gives to the small operator who ventured his capital to make the discovery.

Nonetheless, major oil firms do make enormous investments and take colossal risks in explorations for new sources of gas and oil.

Though enjoying a special-incentive tax, the petroleum industry still bears an extremely heavy federal-income-tax burden; and it pays more state and local taxes than most other industries. The petroleum industry's return on investment is below the national average, and has been declining steadily for the past two years.[5]

The proven domestic reserves of oil and gas furnish the fuel for 73 per cent of the mechanical energy used in this country. These reserves are being consumed faster than they are being replaced[5] — even though the petroleum industry reinvests, in exploration and development, about five times the amount that it benefits from the federal income-tax depletion allowance.

The House-passed version of the Tax Reform Act of 1969 (HR 13270), cutting oil depletion from 27½ per cent to 20 per cent, would impose an estimated $345 million additional annual federal income tax on the oil industry. The Senate Finance Committee voted to reduce oil depletion to 23 per cent. This version of HR 13270 would "cost the oil industry" an estimated $155 million a year.[5]

The industry will have no recourse except to pass the cost on to the consuming public by increasing the price of oil and gas.[6] This, incidentally, would be the first increase in the cost of gasoline since 1948. Petroleum is the only major industry that has not increased its prices to the public in the past 20 years. The ever-rising price of gasoline at filling stations results, exclusively, from rising taxes imposed on gasoline, not from price increases by the industry.

Until and unless we abolish the entire income-tax system and compel the federal government to adopt an equitable taxing system, oil depletion allowance should not be reduced at all. Any reduction will damage segments of this vital industry, increase consumer costs, and decrease the critically-important activities of exploration for, and development of, new sources of supply.

If this happens, the federal government will intervene with special subsidies and controls to direct exploration and development — and the oil industry will no longer operate as an efficient producer of commodities which have become absolutely essential to human existence.

NEXT WEEK: More on tax reform.

FOOTNOTES

(1) *Dan Smoot Report*, April 30, 1962

(2) *Congressional Quarterly Weekly Report*, Aug. 8, 1969, p. 1428

(3) President Nixon's Manpower Message to Congress, *Congressional Quarterly Weekly Report*, Aug. 15, 1969, p. 1523

(4) *Dallas Morning News*, Oct. 24, 1969, p. 1

(5) *Dallas Morning News*, Oct. 18, 1969, p. D2

(6) *Dallas Morning News*, editorials, Oct. 7, 1969, and Oct. 22, 1969

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